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May 8, 2000

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

VIA COURIER

Ms. Magalie Roman Salas
Office of the Secretary
Federal Communications Commission
445 Twelfth Street, SW
Washington, DC 20554

Re: Opposition of ITAA to Applicants' Further Revised Proposal Regarding GTE's Inter-LATA Bakbone Operations; CC Docket No. 98-141

Dear Ms. Salas:

Enclosed please find an original and four copies of a corrected version of a pleading by the Information Technology Association of America (ITAA) in its opposition to Bell Atlantic/GTE's further revised proposal regarding GTE's inter-LATA Internet backbone operations. A few minor edits were not included in the version filed with the Commission on Friday.

If you have any questions regarding this correction, please contact either Jack Nadler at (202) 626-6838 or myself at (202) 626-6632.

Sincerely,

Scott A. Mackoul

Scott A. Mackoul

Enclosures

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ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of GTE Corporation, Transferor, and Bell Atlantic Corporation, Transferee, for Consent to Transfer of Control	CC Docket No. 98-184

OPPOSITION OF THE INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA TO APPLICANTS' FURTHER REVISED PROPOSAL REGARDING GTE'S INTER-LATA INTERNET BACKBONE OPERATIONS

INTRODUCTION AND SUMMARY

The Information Technology Association of America (ITAA) opposes Bell Atlantic and GTE's further revised proposal regarding the disposition of GTE's inter-LATA Internet backbone operations (Genuity). While styled as a contingent option arrangement, the proposal is nothing more than an elaborate artifice to evade compliance with the inter-LATA restrictions contained in Section 271 of the Communications Act.

As demonstrated below, there can be no reasonable doubt that the post-merger Bell Atlantic/GTE (Verizon) ultimately would convert its 9.5 percent equity interest into an 80 percent interest in Genuity, and would thereby derive 80 percent of the benefit of Genuity's appreciation during the time in which Verizon was prohibited from providing in-region, inter-LATA services. Thus, it is indisputable that the proposal would give Verizon an *immediate economic interest* in Genuity substantially in excess of 10 percent. The end-result would be precisely the same as if Verizon had a conventional equity interest in excess of ten percent: it would reduce Verizon's incentives to open its local markets to competition and would give Verizon an incentive to discriminate in favor of Genuity.

The Commission has gone to great lengths to ensure that the BOCs are not allowed to provide in-region, inter-LATA services before they have opened their local markets to competition. The Commission must be wary of sanctioning any arrangement that the BOCs could use to circumvent the Section 271 regime. The Commission, therefore, should hold that: the revised proposal would give Verizon "the equivalent" of an equity interest in excess of 10 percent in Genuity; this would cause Genuity to be an "affiliate" of Verizon; and, therefore, the proposal would violate Section 271 of the Communications Act.[1]

STATEMENT OF INTEREST

The Information Technology Association of America is the principal trade association of the nation's information technology industries. Together with its forty-one regional technology councils, ITAA represents more than 26,000 companies throughout the United States. ITAA's members provide the public with a wide variety of information products, software, and services. Many of ITAA's member companies provide Internet access and other information services.

ITAA has a long-standing interest in the BOC inter-LATA restriction. ITAA's predecessor association – the Association of Data Processing Services Organizations (ADAPSO) – participated actively in the proceedings involving the adoption and implementation of the

[1] While these comments are limited to the issue of whether the proposed arrangement would unlawfully give Verizon the equivalent of an equity interest in excess of ten percent in Genuity, ITAA supports the position taken by other commenters who demonstrate that the proposed arrangement would provide Verizon with an actual equity interest in excess of ten percent in Genuity and/or would provide Verizon with indirect control over Genuity.

Modification of Final Judgment (MFJ). ITAA also played an active role in the congressional enactment, and Commission implementation, of Sections 271 and 272 of the Communications Act. Finally, ITAA previously participated in this proceeding, through its opposition to Bell Atlantic and GTE's ill-conceived and unlawful request that the Commission allow Bell Atlantic to acquire GTE's inter-LATA Internet backbone operations by creating a "single LATA" for this operation.[2]

I. ANY ARRANGEMENT THAT PROVIDES A BOC WITH AN IMMEDIATE ECONOMIC INTEREST IN AN ENTITY THAT PROVIDES IN-REGION, INTER-LATA SERVICES IS "THE EQUIVALENT" OF AN EQUITY INTEREST

In adopting the Telecommunications Act of 1996, Congress correctly recognized that allowing a BOC to have a direct equity interest in excess of ten percent in an entity that provides in-region inter-LATA services would undermine the twin goals of Section 271: it would eliminate the BOC's incentive to open its local markets to competition, while providing the BOC with the incentive to use its monopoly power to distort competition in the inter-LATA market. Congress therefore prohibited a BOC from having such an interest until it opens its local markets to competition.

Congress also recognized that allowing a BOC to enter into certain arrangements that might not technically qualify as equity interests would eliminate the BOC's incentive to open its local markets to competition, and would provide the BOC with the incentive to use its monopoly power to distort competition in the inter-LATA market, in *precisely* the same manner as would allowing the BOC to have a direct equity interest in an entity that provides inter-LATA services.

[2] *See* Letter from Jonathan Jacob Nadler to Hon. William E. Kennard (Apr. 7, 1999).

Consequently, the Act proscribes arrangements that give a BOC "the equivalent" of an equity interest in excess of ten percent in such entities.

This proceeding requires the Commission to adopt a standard to determine whether a given arrangement constitutes the "equivalent" of an equity interest, and to apply that standard to the proposed arrangement. In seeking to establish a standard, the Commission should look beyond the question of whether a particular arrangement would create an equity interest for accounting, tax, or securities law purposes. Rather, the Commission should develop a standard that will promote the dual policy objectives that underlie Section 271 – opening the local market and preventing BOC anti-competitive abuse in the inter-LATA market.[3] The standard should proscribe any arrangement between a BOC and an in-region, inter-LATA service provider that would cause a BOC, acting rationally, to conduct its affairs as if it had an equity interest in excess of ten percent in the service provider.

A BOC's incentives to open its local markets, and to discriminate in favor of a particular inter-LATA service provider, will be based on the economic reality of the particular arrangement

[3] The Commission has been down this road before. In the *Qwest* proceeding, the agency was required to determine whether agreements between two BOCs and the provider of an inter-LATA service violated Section 271. As the Commission recognized, the statute established the controlling legal standard (a BOC may not "provide" in-region, inter-LATA service), but offered little guidance as to whether the complex arrangement developed by the parties ran afoul of this prohibition. In seeking to "give meaning" to the statutory provision, the Commission concluded that it must interpret the statutory terms in a manner that will advance "the dual objectives" of Section 271 – providing the BOCs with "affirmative incentive to open their local markets to competition" and preventing the BOCs from "leverag[ing] their bottleneck control in the local market into the long distance market." *AT&T Corporation v. Ameritech Corporation,* 13 FCC Rcd 21438, 21445 & 21465 (1998) ("*Qwest Order*"). The Commission further made clear that, in assessing a particular agreement, the agency would look beyond the form and would assess the substance of the specific transaction. Thus, despite the fact that the BOCs had styled their arrangement as a "joint marketing agreement," the Commission held that, in reality, the agreements at issue impermissibly allowed the BOCs to provide inter-LATA service. *Id.* at 21474. Finally, the Commission rejected the BOCs' contention that allowing the transaction would be in the public interest. As the agency correctly observed, the public interest is best served "by preserving the intent of Congress that local markets be open to competition before BOCs may enter the long distance market." *Id.* at 21475. The Commission should use the same approach in the present proceeding. The

that the BOC has with the inter-LATA service provider – not on whether the arrangement meets the technical classification of an equity interest. Thus, consistent with the language of the statute, and the dual objectives of Section 271, the Commission should hold that:

> An arrangement between a BOC and an inter-LATA service provider constitutes "the equivalent" of an equity interest in excess of ten percent if the arrangement would give the BOC an *immediate economic interest* in the service provider in excess of ten percent of the service provider's value.

II. THE PROPOSED ARRANGEMENT WOULD GIVE VERIZON AN ECONOMIC INTEREST IN GENUITY THAT WOULD BE SUBSTANTIALLY IN EXCESS OF TEN PERCENT OF GENUITY'S VALUE

Bell Atlantic and GTE have carefully structured the proposed arrangement to conceal its economic impact. The proposed arrangement *appears* to be an option agreement, *appears* to turn on the occurrence of a genuine contingency, and *appears* to subject Verizon to a degree of risk if it does not promptly open its local markets to competition. Under the proposed arrangement, Verizon would "spin off" Genuity into a separate company in return for a 9.5 percent equity interest and an "option" to convert this interest to 80 percent ownership of Genuity. In order for the option to be effective, however, Verizon would need to obtain Section 271 approval to provide inter-LATA services in States accounting for fifty percent of its access lines within five years. If Verizon failed to meet this condition, it could incur a financial loss. Verizon could exercise the option when the Commission grants it Section 271 authorization in States accounting for 95 percent of its access lines.

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fact that *Qwest* concerned voice services, while this matter primarily (but not exclusively) concerns data services, is irrelevant. The Communications Act does not differentiate between voice and data services.

In order to assess the economic consequences of the proposed agreement, however, the Commission must look beyond its form to its substance. There can be no reasonable dispute regarding any of the following four facts:

1. ***Verizon would satisfy the contingency necessary to exercise the option.*** Bell Atlantic and GTE have set the bar shamelessly low. Bell Atlantic currently has Section 271 authority in New York, which accounts for nearly thirty percent of Bell Atlantic's access lines, Verizon would need to obtain Commission approval in just two additional States to meet the fifty-percent threshold. There is no reasonable chance that Verizon would not meet this extremely modest goal within five years from the date the option agreement becomes effective – a date nearly ten years after the adoption of the Telecommunications Act. But, if it doesn't, Verizon could ask the Commission for a further extension. Consequently, there is no realistic possibility that Verizon would incur any financial losses.

2. ***Verizon would exercise the option.*** Nor can there be any reasonable doubt that Verizon would exercise the option. The option would allow Verizon to convert its 9.5 percent equity interest into an 80 percent equity interest at *no additional cost.* In that circumstance, failure to exercise the option would be economically unthinkable. Indeed, failure to do so almost certainly would give rise to a stockholders' action.

3. ***Verizon would derive the same economic benefit that it would have obtained if it held a direct 80 percent equity interest in Genuity during the period in which Verizon was not allowed to fully participate in the inter-LATA market.*** Once Verizon exercised its option, it would acquire an 80 percent equity interest in Genuity. Because Genuity would not be allowed to make significant dividend payments prior to that time, upon exercise of the option, Verizon would own 80 percent of the increase in the value of Genuity that occurred during the period in which Verizon was not permitted to participate in the inter-LATA market. Economically, Verizon would be placed in the same position as if it had owned an 80 percent interest in Genuity from Day One.[4]

4. Financial markets would value Verizon's interest in Genuity as if Verizon had an 80 percent equity interest. Bell Atlantic and GTE have conceded that, under the previous version of their proposal, the capital markets would have placed a value on Verizon's 9.5 percent stock interest plus the option equal to 80 percent of the value of Genuity. Nothing in the current proposal changes this. The risk that Verizon would not be able to get Section 271 approval in two more States within five years is so small that the rational response of the market would be to place no value on it.[5] Thus, whatever the legal status of Verizon's interest in Genuity, Verizon clearly would have an immediate economic interest equal to 80 percent of the value of Verizon.

Given these indisputable market realities, the proposed arrangement plainly would cause Verizon to conduct its affairs, from the outset, in *precisely the same way* as if it had an 80 percent equity interest in Genuity.

[4] The fact that Verizon would not be able to *extract* the benefit of Genuity's appreciation until after Verizon has obtained Section 271 authority in States accounting for 95 percent of its access lines is irrelevant. Verizon is like an investor who seeks to avoid a ban on earning bank interest for one year by buying a certificate of deposit with a one-year maturity date, rather than opening a day-to-day savings account. Under either arrangement, of course, the investor is earning interest *during* that year.

[5] Even if the market were to discount the economic value of Verizon's interest in Genuity to account for this infinitesimal risk, it clearly would still value Verizon's interest substantially in excess of 10 percent of the value of Genuity.

III. THE PROPOSED ARRANGEMENT WOULD UNDERMINE THE DUAL OBJECTIVES OF SECTION 271

The proposed arrangement would undermine both of the objectives of Section 271: Verizon's incentive promptly to open its local market would be reduced, while it would have a substantial incentive to discriminate in favor of Genuity.

Verizon's Incentives to Promptly Open Its Local Markets to Competition. Incumbent monopolists have no incentive to open their markets to competition. Section 271 seeks to provide the BOCs with a significant incentive – the ability to enter the in-region, inter-LATA market. Indeed, the Commission has observed that, without this incentive, "it would be highly unlikely that the competition would develop expeditiously in the local exchange and exchange access markets."[6]

In the present case, the proposed arrangement would not create an incentive for Verizon to open its local markets to competition. The need for Verizon to obtain Section 271 authorization in just *three States* within *ten years* of the enactment of the Telecommunications Act is hardly an incentive to open its markets "expeditiously." To the contrary, because Verizon would be able to reap the benefits of current participation in the inter-LATA market – especially obtaining the economic value of the Verizon's appreciation – allowing it to enter into the proposed arrangement would decrease its incentive to open its local markets.[7]

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[6] *Qwest Order*, 13 FCC Rcd at 21445.

[7] Contrary to the Applicants' contention, the decision of the MFJ Court in the *Tel-Optik Order* – which allowed a BOC to obtain an option to purchase, for a fixed price, an entity that provided inter-LATA services – does not demonstrate that a BOC may derive the economic benefit from the appreciation in value of an inter-LATA service provider during the period between the grant and the exercise of the option. *See United States of America v. Western Electric Company*, Civ. Action 82-0192 (Aug. 7, 1986). The option at issue in *Tel-Optik* required the BOC to make a significant additional payment at the time the BOC exercised the option. While this price was specified in advance, it doubtless reflected the expected increase in the value of the target company during the period between

Verizon's Incentive to Discriminate in Favor or Genuity. Until Verizon fully opens its local markets to competition, it will retain the ability to discriminate against Genuity's competitors in the Internet backbone market. There are numerous ways in which Verizon will be able to do so. For example, Verizon will be able to provide technically superior interconnection, advanced access to network information, or preferential support services to its ISP customers that connect to the Genuity backbone. Individually, instances of discrimination may be difficult to detect. Collectively, they could significantly undermine competition in the Internet backbone market.

The proposed arrangement would give Verizon concrete economic incentives to engage in such discrimination. As a rational market participant, Verizon would conduct its business based on two assumptions: Genuity ultimately will be "re-absorbed" into Verizon and, once it is, Verizon will obtain the benefit of the appreciation in Genuity's value. Consequently, Verizon would have every incentive to strengthen Genuity by discriminating in its favor.[8] The Commission should not sanction an arrangement – no matter how artfully drafted – that would have this result.

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the adoption and exercise of the option. Thus, the BOC was not likely to receive the benefit of the increase in value resulting from the target company's provision of inter-LATA services during the period in which the BOC was forbidden to have a direct equity investment in the target company. Rather, the BOC "paid in advance" for the expected appreciation. Here, by contrast, Verizon would be able to exercise the option at no cost – thereby allowing it to extract 80 percent of the appreciation resulting from Genuity's provision of inter-LATA services during the period in which Verizon was forbidden to have a direct equity investment in excess of ten percent in Genuity.

[8] The Section 271 process is unlikely to serve as an effective deterrent. The Communications Act makes clear that, in evaluating a BOC's Section 271 application, the Commission may only consider whether the BOC has complied with the 14-point competitive checklist. Thus, even if Verizon discriminates in favor of Genuity, this is unlikely to provide a basis for the Commission to deny a Section 271 application in any given State.

CONCLUSION

For the foregoing reasons, the Commission should find that the revised proposal would give Verizon "the equivalent" of an equity interest in excess of 10 percent in Verizon; that this would cause Genuity to be an "affiliate" of Verizon; and, therefore, that the proposal would violate Section 271.

Respectfully submitted,

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